



DEFENSE CONTRACT AUDIT AGENCY
DEPARTMENT OF DEFENSE
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IN REPLY REFER TO

PAC 730.3.B.01/2006-01

April 14, 2006
06-PAC-012(R)

MEMORANDUM FOR REGIONAL DIRECTORS, DCAA
DIRECTOR, FIELD DETACHMENT, DCAA

SUBJECT: Audit Guidance on Revisions to FAR Subpart 31.201-6 Allowing Contractors to Use Statistical Sampling to Identify Unallowable Costs

FAR 31.201-6, *Accounting for Unallowable Costs*, was revised to allow contractors to use statistical sampling as a method of identifying and segregating unallowable costs. The revised rule is effective October 31, 2005. A line-in/line-out version of the changes to FAR 31.201-6 is included as the Enclosure.

It is the contractor's responsibility to identify and segregate unallowable costs, as prescribed in CAS 405. Statistical sampling is just one method the contractor may choose to use in order to comply with the requirements of CAS 405.

If the contractor elects to use statistical sampling to identify and segregate unallowable costs, the revised rule encourages the cognizant Administrative Contracting Officer (ACO) and the contractor to enter into an advance agreement covering the contractor's use of statistical sampling. It requires the ACO to request input from the auditor before entering into any such agreements. The rule also specifically provides that the FAR penalty provisions for unallowable costs would apply to the amount projected to the universe of the sampled items.

If auditors are requested to provide input on an advance agreement or encounter issues relating to a contractor's planned use of statistical sampling to identify and segregate unallowable costs, they should contact DCAA Headquarters, through their region, to obtain advice on a case-by-case basis. This will assure consistent advice on initial proposed sampling plans and provide a basis for determining what additional guidance, if any, may be needed for auditors, should this approach gain widespread application.

Auditors will continue to consider contractor compliance with CAS 405 in their audit planning, regardless of the segregation method used by the contractor. If a compliant contractor opts to use the statistical sampling method in lieu of its existing practice, there is no impact on the auditor's risk assessment or audit procedures necessary to render an audit opinion on the overall allowability, allocability, and reasonableness of the contractor's incurred costs. However, where the auditor subsequently finds expressly unallowable costs, or those designated as unallowable by mutual agreement or a written decision of the contracting officer, these costs shall be considered part of the contractor's projected decrement to its claimed costs, as required by CAS 405.

If FAO personnel have any questions, they should contact regional personnel. If regional personnel have any questions, they should contact Accounting and Cost Principles Division at (703) 767-3250.

/Signed/
Earl J. Newman
Assistant Director
Policy and Plans

Enclosure:

Revised FAR 31.201-6 (Line-In/Out)

DISTRIBUTION: C

Changes to Specified Provisions of FAR Subpart 31.201-6 Line-In/Out

(Changes published in FAC 2005-06, dated September 30, 2005, are noted with underline for additions to the current text and ~~striketrough~~ for deletions).

31.201-6 Accounting for unallowable costs.

(a) Costs that are expressly unallowable or mutually agreed to be unallowable, including mutually agreed to be unallowable directly associated costs, shall be identified and excluded from any billing, claim, or proposal applicable to a Government contract. A directly associated cost is any cost which is generated solely as a result of incurring another cost, and which would not have been incurred had the other cost not been incurred. When an unallowable cost is incurred, its directly associated costs are also unallowable.

(b) Costs which specifically become designated as unallowable or as unallowable directly associated costs of unallowable costs as a result of a written decision furnished by a contracting officer shall be identified if included in or used in computing any billing, claim, or proposal applicable to a Government contract. This identification requirement applies also to any costs incurred for the same purpose under like circumstances as the costs specifically identified as unallowable under either this paragraph or paragraph (a) of this subsection.

(c)(1) The practices for accounting for and presentation of unallowable costs will be those as described in 48 CFR 9904.405, Accounting for Unallowable Costs.

(2) Statistical sampling is an acceptable practice for contractors to follow in accounting for and presenting unallowable costs provided the following criteria in paragraphs (c)(2)(i), (c)(2)(ii), and (c)(2)(iii) of this subsection are met:

(i) The statistical sampling results in an unbiased sample that is a reasonable representation of the sampling universe.

(ii) Any large dollar value or high risk transaction is separately reviewed for unallowable costs and excluded from the sampling process.

(iii) The statistical sampling permits audit verification.

(3) For any indirect cost in the selected sample that is subject to the penalty provisions at 42.709, the amount projected to the sampling universe from that sampled cost is also subject to the same penalty provisions.

(4) Use of statistical sampling methods for identifying and segregating unallowable costs should be the subject of an advance agreement under the provisions of 31.109 between the contractor and the cognizant administrative contracting officer or Federal official. The advance agreement should specify the basic characteristics of the sampling process. The cognizant administrative contracting officer or Federal official shall request input from the cognizant auditor before entering into any such agreements.

(5) In the absence of an advance agreement, if an initial review of the facts results in a challenge of the statistical sampling methods by the contracting officer or the contracting

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Line-In/Out

officer's representative, the burden of proof shall be on the contractor to establish that such a method meets the criteria in paragraph (c)(2) of this subsection.

(d) If a directly associated cost is included in a cost pool ~~that~~ which is allocated over a base that includes the unallowable cost with which it is associated, the directly associated cost shall remain in the cost pool. Since the unallowable costs will attract their allocable share of costs from the cost pool, no further action is required to assure disallowance of the directly associated costs. In all other cases, the directly associated costs, if material in amount, must be purged from the cost pool as unallowable costs.

(e)(1) In determining the materiality of a directly associated cost, consideration should be given to the significance of—

- (i) The actual dollar amount,
- (ii) The cumulative effect of all directly associated costs in a cost pool, and ~~or~~
- (iii) The ultimate effect on the cost of Government contracts.

(2) Salary expenses of employees who participate in activities that generate unallowable costs shall be treated as directly associated costs to the extent of the time spent on the proscribed activity, provided the costs are material in accordance with paragraph (e)(1) of this subsection (except when such salary expenses are, themselves, unallowable). The time spent in proscribed activities should be compared to total time spent on company activities to determine if the costs are material. Time spent by employees outside the normal working hours should not be considered except when it is evident that an employee engages so frequently in company activities during periods outside normal working hours as to indicate that such activities are a part of the employee's regular duties.

(3) When a selected item of cost under 31.205 provides that directly associated costs be unallowable, ~~it is intended that~~ such directly associated costs are ~~be~~ unallowable only if determined to be material in amount in accordance with the criteria provided in paragraphs (e)(1) and (e)(2) of this subsection, except in those situations where allowance of any of the directly associated costs involved would be considered to be contrary to public policy.